Nos. [redacted] 28-29

In the Supreme Court of the United States

October Term, 1943

Claridge Apartments Company, an Illinois Corporation, petitioner

v.

Commissioner of Internal Revenue

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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CITATIONS

577958—44——1

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Nos. 701, 702

CLARIDGE APARTMENTS COMPANY, AN ILLINOIS CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 183-199) is reported in 1 T. C. 163. The opinion of the Circuit Court of Appeals (R. 228-237) has not yet been reported.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on December 1, 1943 (R. 237, 238). A petition for a rehearing was filed by the taxpayer and denied by the Circuit Court of Appeals on December 22, 1943 (R. 238). The petitions

for writs of certiorari were filed on February 15, 1944. Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The taxpayer was formed in 1935 pursuant to a plan of reorganization under Section 77B of the Bankruptcy Act, and acquired all of the assets of the debtor company. (The conclusion of the Tax Court that this acquisition was in connection with a "reorganization" within the meaning of the revenue laws, and hence entitled the taxpayer to use the old corporation's basis in computing depreciation, is not challenged here.) The old bondholders received stock in the new company having a market value substantially less than the face amount of the bonds.

The principal issues in this case are presented by the taxpayer's petition in No. 701:

1. Whether Section 270 of the Bankruptcy Act, as amended, is applicable to the tax years prior to 1938.

2. Whether there was a cancellation or reduction of indebtedness, within the meaning of Section 270 of the Bankruptcy Act, as amended, to the extent of the difference between the face amount of the bonds and the market value of the stock issued to the old bondholders.

The petition in No. 702 presents three subsidiary questions:

3. Whether the Tax Court erred in concluding that the basis should be reduced for the year 1938 to the extent of the accrued unpaid interest on the bonds under Section 270 of the Bankruptcy Act, as amended.

4. Whether the Tax Court's finding of the adjusted basis of the assets in the hands of the old corporation should be sustained.

5. Whether the Tax Court erred in sustaining the Commissioner's disallowance of certain deductions in 1937 on the ground that they were incurred and taken in 1936.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the appendix, *infra*, pp. 14–18.

STATEMENT

The taxpayer is a corporation organized on May 28, 1935, under the laws of the State of Illinois, pursuant to a proceeding under Section 77B of the Bankruptcy Act. It filed its income and excess profits tax returns for the years 1935 to 1938, inclusive, with the Collector of Internal Revenue for the First District of Illinois. (R. 184.)

In determining deficiencies for these tax years, the Commissioner reduced the depreciation allowances claimed by the taxpayer (R. 9, 12, 15–16, 18–19), and disallowed certain deductions claimed for painting, decorating and repairs in the year 1937, on the ground that these expenses were in-

curred during the year 1936 and were claimed in the taxpayer's 1936 return (R. 15). The findings of the Tax Court which are pertinent to the questions presented may be summarized as follows:

In 1924 the Claridge Building Corporation (herein called the Building Corporation) acquired a certain lot in Chicago from Charles F. Henry, pursuant to a contract whereby the Building Corporation agreed to issue and did issue its entire authorized capital stock to Charles F. Henry in consideration therefor. During the spring and summer of 1924, the Building Corporation caused an apartment building to be erected on the lot at a cost of $385,326.37. By August 1, 1935, depreciation amounting to $139,253.71 had been taken on a "cost" of $424,609.19 which included a contractor's commission to Charles F. Henry. (R. 184.)

On March 25, 1924, the Building Corporation issued its 6½-percent first mortgage bonds in the principal amount of $340,000. By October 1, 1931, the bonds were outstanding and unpaid in the principal amount of $277,000. Defaults having occurred both in principal and interest, the trustee filed a bill of foreclosure on October 1, 1931, and all of the bonds were declared immediately due and payable. A decree of foreclosure was entered on February 19, 1932, but there was no sale of the mortgaged property under the decree and

the foreclosure proceeding was never consummated. The trustee took possession of the property and collected the rents after October 1, 1931. (R. 184.)

On June 16, 1934, the Building Corporation filed a voluntary petition in the District Court of the United States for the Northern District of Illinois, Eastern Division, under Section 77B of the Bankruptcy Act as amended (R. 185).

On November 27, 1934, the bondholders' committee, the Building Corporation, and one Minnie H. Case agreed on a reorganization plan. The plan provided for the formation of a new corporation to acquire the property. The new corporation would have an authorized capital stock of 3,080 shares. Ninety percent of the outstanding stock, or 2,770 shares, would be held by trustees, and the trust certificates would be issued to the bondholders on the basis of one share of stock for each $100 face amount of bonds. Ten percent of the stock would go to the old stockholders. (R. 185.) This plan was confirmed and approved by the court by an order dated May 14, 1935. The order stated that the bonds and interest coupons were satisfied and of no further force and effect and authorized the issuance of the new securities. (R. 187.).

The taxpayer was organized pursuant to the plan and the property transferred to it (R. 188). Under the plan the taxpayer's stock was issued

at the rate of one share per $100 face value of the bonds of the old company. The fair market value of the stock never exceeded $45 per share at any time during the year 1935. Of taxpayer's 3,080 shares of common no par value stock, 2,770 shares were issued to nondepositing bondholders and to trustees for the depositing bondholders, 308 shares to old stockholders, and 2 shares remained unissued. (R. 189.)

The final decree in the Section 77B proceeding entered March 1, 1937, declared the first mortgage bonds in the principal amount of $277,000 and interest coupons attached and the trust deed and chattel mortgage which secured them, to be of no further force and effect as against the debtor and its property, and that the holders thereof should be entitled to receive only the new securities provided for in the plan of reorganization (R. 187).

The property in question, including the building and furnishings and the lot on which it was situated, was sold in July 1940, for $126,200, plus an assumption of about $20,000 of liabilities. The market in 1940 was much higher and more active than in 1935. The fair market value of the building, exclusive of the land, as of May 14, 1935 (the date on which the court confirmed the plan), was not in excess of $141,000. The fair market value of the land on that date was $16,000. (R. 190.)

The adjusted basis of the taxpayer's predecessor in 1935 was $239,377.33. At the date of the tax-

payer's acquisition of the property the building had a remaining useful life of 25 years. (R. 190.)

The taxpayer reported its income and deductions on an accrual system of accounting and under this system deducted all expenses for painting, decorating and repairs in the year in which such expenses were paid. In 1936 it included in its expense deductions an amount of $1,219.44 for painting and decorating and $389.60 for repairs expended in that year. These identical items were deducted for a second time in the taxpayer's 1937 return. (R. 190.)

The Commissioner contended that the taxpayer's basis for depreciation of its property was its market value on acquisition in 1935, but the Tax Court concluded (R. 191–194) that the taxpayer had acquired the assets in connection with a reorganization within the definition of Section 112 (g) of the Revenue Act of 1936, as amended, and that therefore its basis for depreciation was the adjusted basis in the hands of the predecessor company (R. 191–193). This conclusion was not challenged on appeal, and is not questioned here.

The Tax Court then considered the Commissioner's alternative contention that in the proceedings under Section 77B the debtor corporation's indebtedness had been "cancelled or reduced" to the extent of the difference between the liability on the bonds and the market value of the stock issued to the bondholders, and that

therefore the basis had to be reduced to the extent of the reduction or cancellation (although not to an amount less than the fair market value of the property at confirmation of the plan) under the provisions of Section 270 of the Bankruptcy Act. It held (R. 195–198): (1) that Section 270 did not apply to the tax years prior to the year 1938; (2) that upon issuance of the stock for the bonds, the indebtedness had not been "cancelled or reduced"; (3) that the accrued and unpaid interest on the bonds was cancelled, and that the cancelled interest could not be excluded from the write-down as "not resulting in a tax benefit on any income tax return"; (4) that the original cost of the building was $385,326.37, as determined by the Commissioner; and (5) that taxpayer was seeking a deduction for 1937 which had already been taken and allowed for a prior year.

Both the Commissioner and the taxpayer appealed to the Circuit Court of Appeals for the Seventh Circuit, the Commissioner questioning the correctness of rulings (1) and (2), and the taxpayer challenging (3), (4), and (5). The court below sustained the Commissioner's contentions with respect to all of these issues (R. 236–237).

ARGUMENT

The principal contention made by the petitioner in these cases relates to the applicability of Section 270 of the Bankruptcy Act, as amended by the Act of June 22, 1938, to tax years prior to 1938.

That section provides for the reduction of the basis of property acquired in reorganization proceedings under the Bankruptcy Act, where the old basis carries over, to the extent that a corporate debt is canceled or reduced in such proceedings.[1]

Section 276c (3) of that Act (Appendix, *infra*, p. 16) provides that—

> sections 268 and 270 of this Act shall apply to any plan confirmed under section 77B before the effective date of this amendatory Act and to any plan which may be confirmed under section 77B on and after such effective date, * * *.

The taxpayer's plan of reorganization was confirmed and approved by an order of the court on May 14, 1935. The taxable years in question are 1935, 1936, 1937, and 1938. The Tax Court held that notwithstanding Section 276c (3), Section 270 applies only to 1938, the year in which the amendment was passed.

The court below reversed, holding that apart from the inferences to be drawn from the relation of Sections 268 (Appendix, *infra*, p. 14)[2] and

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[1] A further amendment of July 1, 1940 (Appendix, *infra*, p. 15), placed a floor beneath the reduction, by providing that in no case shall the basis be reduced below the fair market value of the property on the date of the order confirming the plan.

[2] Section 268 relieves the debtor corporation of tax on any income or profit represented by an adjustment of indebtedness in a reorganization proceeding under Section 77B of the Bankruptcy Act, as amended.

270, the language of Section 276c (3) compels the conclusion that Section 270 applies in this case to the years 1935, 1936, and 1937, as well as to the year 1938.

While we believe the decision below is correct, it is clearly in conflict with *Commissioner* v. *Commodore, Inc.*, 135 F. 2d 89, in which the Circuit Court of Appeals for the Sixth Circuit sustained the ruling of the Tax Court that Section 270 does not apply to years prior to 1938. The importance of the question is diminished, however, by the fact that the records of the Bureau of Internal Revenue do not disclose any substantial number of cases involving this question. Moreover, as the result of a recent amendment to the Internal Revenue Code,[3] the question of the effect and applicability of Section 270 in these situations may not arise in cases involving tax liability for years beginning on or after January 1, 1943.

The second question presented in No. 701 is whether there was a cancellation or reduction of the debtor's indebtedness, within the meaning of the Bankruptcy Act, when, pursuant to the plan of reorganization, shares of stock in the new corporation, worth less than the debtor's bond indebtedness, were issued to the old bondholders.

The court below reversed the Tax Court and sustained the Commissioner's contention that the

[3] Section 121 (c) (3) and (e), Revenue Act of 1943, Public Law 235, 78th Cong., 2d Sess.

debtor's bond indebtedness was canceled or reduced to the extent of the difference between the face amount of the bonds and the market value of the stock issued. We believe that the Tax Court's conclusion rests upon a basic misconception of corporate law. It is apparently based upon the theory that the assets were not freed from obligation, for, although the bond loan had been terminated, the amount borrowed was committed to capital stock liability, by the issuance of stock, instead of to the liability of a fixed indebtedness. This reasoning necessarily assumes that the capital stock of a corporation is a liability, in disregard of the recognized principle that stock represents ownership, not debt. As stated by the court below, the words "cancelled or reduced" as used in the statute, are comprehensive and manifestly were intended to cover this type of situation. There was an elimination of the bond indebtedness which wiped out a direct debt liability, enforceable by legal action. As to this question, no conflict is asserted.[4]

The analogue of this question, i. e., whether there was a cancellation or reduction of the principal of the indebtedness, is presented by the petition in No. 702, namely, whether there was a cancellation or reduction of the accrued unpaid interest which has resulted in a tax benefit to the petitioner on

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[4] The same question is now pending before the Circuit Court of Appeals for the Sixth Circuit in *Commissioner v. Alcazar Hotel, Inc.*, No. 9678.

any income tax return. The Tax Court found that, even though there had been no cancellation or reduction of the principal indebtedness, accrued unpaid interest had been cancelled. However, in view of its conclusion that Section 270 applied only to the year 1938, no reduction of basis on account of the interest cancelled was allowed as to the prior tax years.

If, by reason of the conflict in the decisions as to whether Section 270 applies to years prior to 1938, this Court should determine to grant certiorari in order to resolve such conflict, it would seem appropriate that the review should also include the related questions as to the cancellation or reduction of the principal debt and the accrued unpaid interest. Any holding by the Court on the question of the retroactivity of Section 270 obviously would affect the determination of these questions.

However, the two remaining questions presented in No. 702—whether the Tax Court's finding of the adjusted basis of the assets in the hands of the old corporation should be affirmed, and whether the Tax Court erred in sustaining the Commissioner's disallowance of certain deductions in 1937 on the ground that they were incurred and taken in 1936—are unrelated to the retroactivity question, and do not warrant further review by this Court. They plainly involve only issues of fact, and the findings of the Tax Court were correctly sustained

by the court below as supported by the evidence. *Dobson* v. *Commissioner*, Nos. 44–47 this Term, decided December 20, 1943, rehearing denied February 14, 1944.

CONCLUSION

While the decision below is correct, it is clearly in conflict with a ruling of the Circuit Court of Appeals for the Sixth Circuit with respect to the retroactivity of Section 270 of the Bankruptcy Act, as amended. However, the importance of this question is not clear. If certiorari should be granted in order to resolve such conflict, we believe that the review should extend only to the determination of other questions which would be affected by the decision on the retroactivity question, i. e., whether there was a cancellation or reduction of the principal indebtedness and the accrued unpaid interest.

Respectfully submitted.

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MARCH 1944.

APPENDIX

Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as amended by the Act of June 22, 1938, c. 575, 52 Stat. 840:

Sec. 268. Except as provided in section 270 of this Act, no income or profit, taxable under any law of the United States or of any State now in force or which may hereafter be enacted, shall, in respect to the adjustment of the indebtedness of a debtor in a proceeding under this chapter, be deemed to have accrued to or to have been realized by a debtor, by a trustee provided for in a plan under this chapter, or by a corporation organized or made use of for effectuating a plan under this chapter by reason of a modification in or cancelation in whole or in part of any of the indebtedness of the debtor in a proceeding under this chapter. (11 U. S. C., Sec. 668.)

Sec. 269. Where it appears that a plan has for one of its principal purposes the avoidance of taxes, objection to its confirmation may be made on that ground by the Secretary of the Treasury, or, in the case of a State, by the corresponding official or other person so authorized. Such objections shall be heard and determined by the judge, independently of other objections which may be made to the confirmation of the plan, and, if the judge shall be satisfied that such purpose exists, he shall refuse to confirm the plan. (11 U. S. C., Sec. 669.)

SEC. 270 [as further amended by the Act of July 1, 1940, c. 500, 54 Stat. 709]. In determining the basis of property for any purposes of any law of the United States or of a State imposing a tax upon income, the basis of the debtor's property (other than money) or of such property (other than money) as is transferred to any person required to use the debtor's basis in whole or in part shall be decreased by an amount equal to the amount by which the indebtedness of the debtor, not including accrued interest unpaid and not resulting in a tax benefit on any income tax return, has been canceled or reduced in a proceeding under this chapter, but the basis of any particular property shall not be decreased to an amount less than the fair market value of such property as of the date of entry of the order confirming the plan. Any determination of value in a proceeding under this chapter shall not be deemed a determination of fair market value for the purposes of this section. The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe such regulations as he may deem necessary in order to reflect such decrease in basis for Federal income-tax purposes and otherwise carry into effect the purposes of this section. (11 U. S. C., Sec. 670.)

SEC. 276. * * *

* * * * *

c. the provisions of sections 77A and 77B of chapter VIII, as amended, of the Act entitled "An Act to establish a uniform system of bankruptcy throughout the United States", approved July 1, 1898, shall continue in full force and effect with respect to

proceedings pending under those sections upon the effective date of this amendatory Act; except that—

(1) if the petition in such proceedings was approved within three months prior to the effective date of this amendatory Act, the provisions of the chapter shall apply in their entirety to such proceedings; and

(2) if the petition in such proceedings was approved more than three months before the effective date of this amendatory Act, the provisions of this chapter shall apply to such proceedings to the extent that the judge shall deem their application practicable; and

(3) sections 268 and 270 of this Act shall apply to any plan confirmed under section 77B before the effective date of this amendatory Act and to any plan which may be confirmed under section 77B on and after such effective date, except that the exemption provided by section 268 of this Act may be disallowed if it shall be made to appear that any such plan had for one of its principal purposes the avoidance of income taxes, and except further that where such plan has not been confirmed on and after such effective date, section 269 of this Act shall apply where practicable and expedient. (11 U. S. C., Sec. 676.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934, as amended by T. D. 4871, 1938-2 Cum. Bull. 130, and T. D. 5003, 1940-2 Cum. Bull. 107, 108-109:

ART. 113 (b)-2. *Adjusted basis: Cancellation of indebtedness.*—In addition to the adjustments provided in section 113 (b) (1) and article 113 (b)-1 which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in any case in

which there shall have been a cancellation or reduction of indebtedness in any proceeding under section 12, 74 (except in the case of a "wage earner" as defined in the Bankruptcy Act, as amended), or 77B of the Bankruptcy Act of 1898, as amended. * * *

* * * * *

For the purposes of this article—

(A) Basis shall be determined as of the date of entry of the order confirming the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced;

(B) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(C) No adjustment shall be made by virtue of the cancellation or reduction of any accrued interest unpaid which shall not have resulted in a tax benefit in any income tax return;

(D) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay; and

(E) The term "fair market value" has reference to such value as of the date of entry of the order confirming the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced.

Any determination of value in a proceeding under the Bankruptcy Act, as amended, shall not constitute a determination of fair market value for the purposes of this article.

> The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this article.

Article 113 (b)-2, Treasury Regulations 94, as amended by the same Treasury Decisions, is identical with the above-quoted article.

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